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NOTES

RANDALL v. LOFTSGAARDEN: DEMISE OF THE TAX BENEFIT DEFENSE IN TAX SHELTER SECURITIES FRAUD LITIGATION—A RETURN TO JUDICIAL “NEVER-NEVER LAND”¹

Courts generally do not consider the impact of federal income taxes when awarding civil damages.² In personal injury and wrongful death litigation, this practice is followed whether the issue involves the effect of income taxation upon future earnings in computing damages,³ or the admissibility of evidence regarding the tax treatment of the damage award itself.⁴ The courts defend this approach based on several public policy arguments including: the speculative nature of an individual's future income

1. "Requiring the jury or this Court to try this case without reference to the tax consequences of the transaction would be requiring the jury and the Court to live in an artificial 'never-never land'. . . and is tantamount to requiring this Court and the jury to try this case blindfolded." *Bridgen v. Scott*, 456 F. Supp. 1048, 1061 (S.D. Tex. 1978).

2. "[M]ost courts have refused to deduct the income tax savings from the award [for personal injury], and likewise have refused to instruct the jury that the award is not taxable." D. DOBBS, *HANDBOOK ON THE LAW OF REMEDIES* § 8.8, at 576 (1973) (citations omitted). "Most appellate courts which have been confronted with the issue of the effect of income taxes on awards have upheld refusals to admit evidence or to instruct the jury on such issues." 4 M. MINZER, C. KIMBALL & D. AXELROD, *DAMAGES IN TORT ACTIONS* §§ 38.31, 38-64 (1987) (citations omitted) [hereinafter *DAMAGES IN TORT ACTIONS*].

3. "The amount of an award of tort damages is ordinarily not diminished because of the fact that although the award is not itself taxed, all or a part of it is to compensate for the loss of future benefits that would have been subject to taxation." *RESTATEMENT (SECOND) OF TORTS* § 914A(2) (1977). See, e.g., *Rueter v. United States*, 534 F. Supp. 731, 733 (W.D. Pa. 1982) ("Under present Pennsylvania tort law, loss of future earnings or earning power . . . is to be awarded in full without reduction for putative income tax thereon."); *Draisma v. United States*, 492 F. Supp. 1317, 1327 (W.D. Mich. 1980) (under Michigan law, damages awarded for a decrease in earning capacity should not be reduced by the proportion the plaintiff would normally have paid in federal, state, and local income taxes); *Seely v. McEvers*, 115 Ariz. 171, 174, 564 P.2d 394, 397 (1977) ("We adopt the majority rule and hold that the gross pay and not the net or 'take home' pay is the proper basis for computing loss of future earnings, and that the evidence of income taxes or deductions should not be allowed for the purpose of reducing the amount of damages.").

4. "The amount of an award of tort damages is not augmented or diminished because of the fact that the award is or is not subject to taxation." *RESTATEMENT (SECOND) OF TORTS* § 914A(1) (1977). See, e.g., *Anunti v. Payette*, 268 N.W.2d 52, 55 (Minn. 1978) (lower court was correct in refusing to instruct the jury in negligence action that any damages award would not be subject to taxation); *Hall v. County of New Madrid*, 645 S.W.2d 149, 151-52 (Mo. App. 1982) (trial court, in personal injury action, was correct in refusing to instruct the jury that any award made to the plaintiff would not be subject to federal or state income taxes); *Salsgiver v. E.S. Ritter Co.*, 42 Or. App. 547, 550, 600 P.2d 951, 952 (1979) (jury instruction that any damages, awarded in a personal injury action, would be tax exempt is not required in cases which do not involve federal substantive law).

tax liability;⁵ the allowance of discovery regarding tax matters which results in evidence that is too complicated for the court to consider;⁶ the nature of plaintiff's tax liability which involves the plaintiff and the government and does not concern the defendant;⁷ and the exemption of damage awards from taxation which, if taken into account by the jury, might cause the plaintiff not to realize the intended tax benefit.⁸ Courts ignore the impact of income taxes in commercial litigation because such damages are usually subject to taxation and this prevents the plaintiff from receiving an undeserved windfall.⁹ Until recently, the circuit courts of appeal have been divided on the issue of whether rescission or rescissionary damages awarded in an action for tax shelter¹⁰ fraud, pursuant to the federal securities laws,

5. See, e.g., *McWeeney v. New York, N.H. & H. R.R.*, 282 F.2d 34, 37 (2d Cir. 1960) (larger damage award because tax consequences were ignored was likely to be offset by attorneys' fees and the impact of inflation); *Oddo v. Cardi*, 100 R.I. 578, 585, 218 A.2d 373, 377 (1966) (effect of federal income taxes on gross earnings should not be considered in computing damages for lost wages "on the ground that the quantum of such taxation is of necessity in the realm of conjecture").

6. See, e.g., *Highshew v. Kushto*, 235 Ind. 505, 507, 134 N.E.2d 555, 556 (1956) ("Such subject matter would involve intricate instructions on the tax and non-tax liabilities with all the regulations pertinent thereto. No court could, with any certainty, properly instruct a jury without a tax expert at its side."); *Hinzman v. Palmanteer*, 81 Wash. 2d 327, 333, 501 P.2d 1228, 1232 (1972) ("[T]o introduce an income tax matter into a lawsuit for damages would be unduly complicating and confusing.").

7. See, e.g., *Hall v. Chicago & N.W. Ry.*, 5 Ill. 2d 135, 151, 125 N.E.2d 77, 86 (1955) ("Whether the plaintiff has to pay a tax on the award is a matter that concerns only the plaintiff and the government. The tortfeasor has no interest in such question.").

8. Section 104 of the Internal Revenue Code excludes from gross income "the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury or sickness." I.R.C. § 104(a)(2) (1982). See *Norfolk & W. Ry. v. Liepelt*, 444 U.S. 490 (1980). The Supreme Court held that evidence and jury instructions relating to the tax free treatment of certain wrongful death awards were allowed. The Court was concerned that a jury, in such cases, might over-compensate the plaintiff based on the mistaken assumption that the award would be fully taxable. *Id.* at 496-97. For a detailed discussion of *Liepelt*, see Note, *Jury Review of Tax Consequences of FELA Damage Awards Now Considered Appropriate*, 26 LOY. U. CHI. L.J. 409 (1980); Note, *Income Taxation and the Calculation of Tort Damage Awards: The Ramifications of Norfolk & Western Railway v. Liepelt*, 38 WASH. & LEE L. REV. 289 (1981).

9. For example, damages recovered for the loss of profits are includable in gross income since business profits are includable in gross income. 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 6A.21 (rev. ed. 1986). Damages for the destruction of property or for an injury to the goodwill of a business are taxable to the extent that the award exceeds the adjusted basis of the property. *Id.* The IRS has asserted that damages for wrongful death are includable in gross income where the state courts have labeled the damages as punitive in nature. Rev. Rul. 84-108, 1984-2 I.R.B. 32. However, this position has not been consistently followed by the courts. See, e.g., *Burford v. United States*, 642 F. Supp. 635, 636 (N.D. Ala. 1986) ("The court is of the opinion that Revenue Ruling 84-108 constitutes an unwarranted administrative amendment of the clear language of the Internal Revenue Code and cannot stand."). See *supra* note 8 (relevant Internal Revenue Code text).

10. "A 'tax shelter' can have various meanings and take various forms." J. FREELAND, S. LIND & R. STEPHENS, FUNDAMENTALS OF FEDERAL INCOME TAXATION 444 (5th ed. 1985). "The

should be reduced by the amount of the tax benefits realized by the plaintiff-investor. The Second¹¹ and Eighth Circuits¹² have held that the defendant should be allowed to reduce his payment for damages by asserting this tax benefit defense, while the Ninth Circuit¹³ has held that such a reduction in damages is inappropriate. The Securities and Exchange Commission (SEC) and the Internal Revenue Service (IRS) support the latter view.¹⁴ A division, however, exists in the lower courts as to both allowing¹⁵ and denying¹⁶

common characteristic of a tax shelter is the generation of tax losses which are available as deductions under the present tax laws, not only against the income from the tax shelter, but also against the taxpayer's income from other sources." Weisner, *Tax Shelters—A Survey of the Impact of The Tax Reform Act of 1976*, 33 TAX L. REV. 5, 6-8 (1978). See generally W. DROLLINGER, *TAX SHELTERS AND TAX-FREE INCOME FOR EVERYONE* (3d ed. 1977); STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94th Cong., 1st Sess. (Comm. Print 1975).

11. *Freschi v. Grand Coal Venture*, 767 F.2d 1041 (2d Cir. 1985), *vacated and remanded*, 106 S. Ct. 3325 (1986). *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984), *vacated and remanded*, 106 S. Ct. 3325 (1986). See *infra* notes 62-88 and accompanying text.

12. *Austin v. Loftsgaarden*, 675 F.2d 168 (8th Cir. 1982), *aff'd en banc*, 768 F.2d 949 (8th Cir.), *cert. granted sub nom. Randall v. Loftsgaarden*, 106 S. Ct. 379 (1985). See *infra* notes 48-54 and accompanying text.

13. *Western Fed. Corp. v. Erickson*, 739 F.2d 1439 (9th Cir. 1984); *Burgess v. Premier Corp.*, 727 F.2d 826 (9th Cir. 1984). See *infra* notes 55-61 and accompanying text.

14. *Amicus curiae* briefs, arguing against the tax benefit defense, were filed by the SEC and the Department of Justice on behalf of the IRS in *Salcer v. Envicon Equities, Corp.*, 812 F.2d 713 (2d Cir. 1984). See *infra* notes 64-76 and accompanying text. The IRS and SEC filed a joint *amicus curiae* brief in *Randall v. Loftsgaarden*, 106 S. Ct. 3143 (1986). See *infra* notes 119-25 and accompanying text.

15. Decisions recognizing the tax benefit defense include *In re Towner Petroleum, No. MDL-607* (E.D. Pa. June 30, 1986) (LEXIS, Genfed library, Dist file) ("It appears that the discovery sought with respect to the plaintiff's taxes is relevant and is reasonably calculated to lead to admissible evidence."); *Herber v. Omega Oil Corp.*, No. 85-C-384 (N.D. Ill. Nov. 4, 1985) (LEXIS, Genfed library, Dist file) (plaintiff's "recovery in a rescissionary remedy should probably be reduced by any 'tax shelter' or other benefit he received as a result of his investment"); *Feldman v. Pioneer Petroleum, Inc.*, 606 F. Supp. 916, 923 (W.D. Okla. 1985) ("It is clear that the tax advantage received by a plaintiff is an appropriate consideration in evaluating actual damages in a tax shelter case such as this."); *Smith v. Bader*, 83 F.R.D. 437, 439 (S.D.N.Y. 1979) ("Knowledge of plaintiffs' income tax rate and the net value of their investment, along with other information, may be needed to calculate any tax benefits which may mitigate damages."); *Bridgen v. Scott*, 546 F. Supp. 1048, 1061-62 (S.D. Tex. 1978) (evidence as to tax consequences of a speculative real estate investment was admissible).

16. Decisions rejecting the tax benefit defense include *Western Fed. Corp. v. Davis*, 553 F. Supp. 818, 820-21 (D. Ariz. 1982), *aff'd sub nom. Western Fed. Corp. v. Erikson*, 739 F.2d 1439 (9th Cir. 1984) (defendants should not be given any credit for the tax benefits received by the plaintiffs); *Spatz v. Borenstein*, 513 F. Supp. 571, 586 (N.D. Ill. 1981) ("The fact that plaintiffs may be better off vis-a-vis the government does not warrant the discarding of a remedy specifically enumerated by the Securities Act."); *Rhode v. Hershberger Exploration Inc.*, 349 F. Supp. 993, 994 (D. Minn. 1972) (not improper for trial court to exclude evidence relating to tax benefits obtained by plaintiffs). See also *Eisenberg v. Gagnon*, 766 F.2d 770, 782 (3rd Cir. 1985) (deductibility of losses not to be considered in assessing damages); *Harris v. Metro. Mall*, 112 Wis. 2d 487, 501-02 n.21, 334 N.W.2d 519, 526 n.21 (1983) (tax consequences of a tax shelter do not reduce restitutionary recovery).

the defense.¹⁷

The tax offset issue is critical in securities litigation since it can have a tremendous impact on the amount of damages awarded and may even determine whether an investor decides to bring suit at all.¹⁸ In *Randall v. Loftsgaarden*,¹⁹ the United States Supreme Court evaluated the viability of the tax benefit defense in light of the statutory language of section 12(2) of the Securities Act of 1933²⁰ and section 28(a) of the Securities and Exchange Act of 1934,²¹ as well as the general policy considerations behind the federal securities laws.²²

This Note will discuss the circuit court decisions and their divergent positions on the tax benefit defense. The Supreme Court's holding in

17. See generally Shoptalk, 41 J. TAX'N 125 (1974); Shoptalk, 42 J. TAX'N 127 (1975) (discussing early cases and their divergent holdings on the issue).

18. For example, the defendants' liability in *Burgess* was determined to be \$496,000 before the tax benefits were considered and only \$157,000 after the tax offset. 727 F.2d at 838. The defendants' liability in *Austin* was determined to be \$294,000 before the tax benefits were considered and only \$29,000 after the offset. Brief for Petitioners at 7-8, *Randall v. Loftsgaarden*, 106 S. Ct. 3143 (1986) (No. 85-519) [hereinafter Brief for Petitioners].

19. 106 S. Ct. 3143 (1986).

20. Section 12(2) of the Securities Act of 1933 reads as follows:

Any person who . . .

(2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him who may sue either at law or in equity in any court of competent jurisdiction, to recover the *consideration paid* for such security with interest therein, less the amount of any *income received thereon* upon the tender of such security, or damages if he no longer owns the security.

15 U.S.C. § 77(2) (1982) (emphasis added).

21. Section 28(a) of the Securities Exchange Act of 1934 reads as follows:

The rights and remedies provided by [the Securities Exchange Act of 1934] shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of [the Securities Exchange Act of 1934] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his *actual damages* on account of the act complained of.

15 U.S.C. § 78bb(a) (1982) (emphasis added).

22. In 1933, President Roosevelt appealed to Congress and sought passage of the Securities Act of 1933: "This proposal adds to the ancient rule of caveat emptor, the further doctrine, 'Let the seller also beware.' It puts the burden of telling the whole truth on the seller. *It should also give impetus to honest dealing in securities . . .*" 77 CONG. REC. 937 (1933) (emphasis added). The Preamble to the 1933 Securities Act states that its purpose is to: "Provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof . . ." 47 Stat. 74 (1933) (emphasis added). Both quotes were included in Brief for Petitioners, *supra* note 18, at 32.

Randall will then be analyzed and its potential impact evaluated. This Note proposes that the Supreme Court misconstrued section 12(2) of the 1933 Act and section 28(a) of the 1934 Act, as well as the direct product and collateral source rules²³ when it excluded the consideration of tax benefits when calculating damages. Such tax benefits, as well as the tax treatment of the damage award, must be considered if the courts are to make a realistic attempt to return the plaintiff-investor to the *status quo ante* which is the measure of damages provided under the law. While it may be argued that this form of damages is too lenient and therefore inadequately insures the realization of the public policy goals behind the federal securities laws, Congress, and not the courts, must provide for a harsher measure of damages.

Finally, this Note concludes that the *Randall* Court's failure to address the tax consequences of rescissionary damages has allowed confusion surrounding the tax treatment of such awards to continue and Congress and the IRS have no incentive to clarify the law.

I. BACKGROUND

During the past few years, tax shelter investments have been subjected to tighter restrictions under the federal tax laws,²⁴ and have been closely monitored by the IRS and the courts.²⁵ In addition, tax shelter limited partnership interests are generally treated as securities under the provisions of the federal securities law²⁶ and are subject to regulation by the

23. See *infra* notes 168-79 and accompanying text (discussion of direct product and collateral source rules).

24. For example, the 1984 Tax Reform Act imposed strict requirements on promoters of "potentially abusive tax shelters" as defined by I.R.C. § 6112(b) (Supp. 1985). Promoters who market such tax shelters are required to register the investments with the IRS, I.R.C. § 6111(a)(1) (Supp. 1985), and maintain a list of clients. *Id.* § 6112(a). Promoters are also required to furnish each investor who purchases such a shelter with its IRS identification number. *Id.* § 6111(b)(1). This number must be included in the investor's return. *Id.* § 6111(b)(2). Penalties are imposed for failing to meet these requirements. See *id.* §§ 6707, 6708. Harsher penalties are imposed under sections 1532-1534 of the Tax Reform Act of 1986 which amended these provisions.

25. In November 1983, the Justice Department's Tax Division created a special litigation unit to deal with cases under the injunctive penalty provisions of the Internal Revenue Code which was created to stop illegal tax shelter promotions. Rollins, Patton, & Friedman, *IRS Freeze On "Abusive Tax Shelter" Refunds; How It Works and Who Will Be Affected*, 34 TAX'N FOR ACCTS. 270 (1985). See *Deegan v. Comm'r*, 787 F.2d 825 (2d Cir. 1986) (disallowed deductions and tax credits generated by limited partnership investments in two film productions that were not activities engaged in "for profit"). *Honodel v. Comm'r*, 722 F.2d 1462 (9th Cir. 1984) (disallowed depreciation deductions for an investment in residential real estate that were computed according to the "economic useful life" of the investment rather than the Internal Revenue Code standards).

26. Section 2(1) of the Securities Act of 1933 reads as follows:

The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transfer-

SEC.²⁷ Consequently, a defrauded tax shelter investor may sue for recovery

able share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or in general any interest or participation in temporary or interim certificate for, receipt for, guarantee of, warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77(b)(1) (1982). The definition does not mention real estate interests. However, such interests are covered by SEC Securities Act Release No. 33-4877 (Aug. 8, 1967):

Under the Federal Securities Laws, an offering of a limited partnership interests and interests in joint or profit-sharing real estate ventures generally constitutes an offer of a "profit sharing agreement" or "an investment contract" which is security within the meaning of section 2(1) of the Securities Act of 1933. The Supreme Court has said that an "investment contract" is a contract, transaction or scheme whereby a person invests money in a common enterprise and is led to expect profits from the efforts of the promoter and or a third party.

Securities and Exchange Commission v. W.J. Howey, 328 U.S. 293, 298, 299 (1946). In other words, the investor provides the capital and shares the risk and the profits; the promoter or third party manages, operates, and controls the enterprise, usually without active participation on the part of the investor. See also United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975) (defining a security as "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others").

27. Tax shelter investments have become increasingly popular in the past few years. "In a recent year, about two-thirds of the 15,000 private offerings made under SEC Regulation D, 17 C.F.R. § 230.501 (1986) were limited partnerships and thus presumably tax shelter ventures." SEC Directorate of Economic and Policy Analysis, *An Analysis of Regulation D*, at i-ii (May, 1984) (cited in Brief of U.S. and SEC as Amici Curiae at 1, *Randall v. Loftsgaarden*, 106 S. Ct. 3143 (1986) (No. 85-519)) [hereinafter Brief of Amici Curiae]. The total invested in limited partnerships in 1984 is estimated to be \$19 billion. R. HAFT & P. FASS, *TAX SHELTERED INVESTMENTS* vii (3d ed. 1985). Consequently, a substantial amount of litigation has involved tax shelters. At the present time, over 30,000 cases, 40% of the Tax Court's docket, involve tax shelters. Brief of Amici Curiae, *supra* at 30. Most tax shelters are organized as limited partnerships because a partnership is not taxed as a separate entity but rather its income and losses pass through directly to the partners. P. GOLDSTEIN, *REAL ESTATE TRANSACTIONS* 830-31 (2d ed. 1985). See I.R.C. § 701 (1982).

Under I.R.C. § 465 (1982), the individual partners may deduct losses from certain partnership activities only to the extent they are "at risk" with respect to the activity. W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* v.1 § 10.11[1] (1986). The amount "at risk" is generally composed of three components:

1. The partner's cash contributions to the partnership,
2. The adjusted basis of the other property contributed to the partnership, and
3. Amounts borrowed by the partnership for which the partner is personally liable.

Tax Reform Act of 1986, H.R. REP. NO. 841, 99th Cong., 2d Sess. II-134 (1986). Real estate activities are specifically excluded from the "at risk" provisions under I.R.C. § 465(c)(3)(D) (1982). This exclusion continues under the Tax Reform Act of 1986 provided that, in the case of nonrecourse financing, the lender is a person or business regularly engaged in the trade, or business of lending money (i.e., is a "commercial lender"). See H.R. 3838, 99th Cong., 2d Sess. § 503(b)(6) (1986).

More importantly, losses from trade or business activities in which the taxpayer does not materially participate (e.g., limited partnerships) may not offset other income such as salary, interest, dividends and active business income. Tax Reform Act of 1986, H.R. No. 841, 99th Cong., 2d Sess. H7633 (Sept. 18, 1986). In the case of real estate rental activities, in which the taxpayer does actively participate, up to \$25,000 of these losses may be used to offset "non-passive" income. *Id.* These provisions are effective for taxable years beginning after December

under both section 12(2) of the Securities Act of 1933²⁸ and Rule 10b-5, promulgated pursuant to the Securities and Exchange Act of 1934.²⁹ The Supreme Court has held that section 28(a) of the 1934 Act should be used for guidance in determining damages under Rule 10b-5.³⁰

The recognized standard for measuring damages under Rule 10b-5 is the "out-of-pocket rule" by which courts award the plaintiff-investor the difference between the purchase price of the securities and their actual value.³¹ Section 12(2) of the 1933 Act³² specifically provides for rescission or rescissionary damages and a majority of courts have held that such damages are also recoverable under Rule 10b-5.³³ The initial contract, therefore, is rendered void and the investor recovers his consideration

31, 1986 with a phase-in rule for investments made before the date of enactment. *Id.* Combined with the reduction in individual tax rates brought in with the new Act, these provisions will make limited partnership tax shelters a much less attractive investment in the future. Some tax experts predict, however, that the new Act will increase the demand for "Master Limited Partnership" interests which are publicly traded and may generate passive income that flows through directly to the taxpayer. Daily Tax Report (BNA) No. 204, at G-6 (Oct. 22, 1986). This income may be reduced by tax shelter losses. *Id.*

28. See *supra* note 20 (text of statute).

29. Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or any facility of any national securities exchange,

a) to employ any device, scheme, or artifice to defraud,

b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading,

c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1986).

30. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (damages for violations of Rule 10b-5 by bank employees were computed in accordance with section 28(a)); *supra* note 21 (text of section 28(a)).

31. See *Harris v. American Inv. Co.*, 523 F.2d 220, 225 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976); L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 1133-34 (1983); D. DOBBS, *supra* note 2, § 9.2, at 595. This was the method of computing damages applied by the courts in common law fraud cases prior to *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938). L. Loss, *supra* at 1133. To the extent the value of the securities is not readily determinable, reasonable inferences may be made. *Id.* at 1134.

32. L. Loss, *supra* note 31, at 1022 ("Section 12(2) can be best analyzed and evaluated by comparing it with common law or (equitable) rescission, from which it was adapted."); *Wigand v. Flotek*, 609 F.2d 1028, 1035 (2d Cir. 1979) (under section 12(2) a plaintiff is entitled to rescission if he still owns the stock and damages if he does not).

33. See, e.g., *In re LTV Sec. Litig.*, 88 F.R.D. 134, 148-49 (N.D. Tex. 1980) (plaintiff may choose rescission under Rule 10b-5); *Abrahamson v. Fleschner*, 392 F. Supp. 740 (S.D.N.Y. 1975), *aff'd in part and rev'd in part*, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978) (plaintiff may choose rescission or a money judgment tantamount to rescission). See generally Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349 (1984).

which was given in exchange for the securities purchased, i.e., the parties are returned to the *status quo ante*.³⁴

Returning the investor in a tax shelter limited partnership to the *status quo ante* upon rescission of the investment, however, is difficult because the investor is likely to have received substantial tax benefits.³⁵ If these tax benefits are permanent and the investor recovers his consideration, the investor will be placed in a better position than he was prior to the transaction.³⁶ If the investor's damages are reduced by the amount of tax benefits realized and the previous benefits are completely or partially disallowed by the IRS, the investor will be placed in a worse position than he was prior to the transaction.

In 1964, two district court decisions, *Cooper v. Hallgarten*³⁷ and *Weisenberger v. W.E. Hutton & Co.*,³⁸ held that tax benefits realized from investment losses could not be used to offset the investor's subsequent award for damages.³⁹ In *Cooper*, the court reasoned that the offset should not be allowed because any recovery by the plaintiff-investor would be subject to taxation and the benefits previously recognized would be eliminated.⁴⁰ In addition, the court noted the inequity of awarding different amounts of damages to plaintiffs who sustained the same loss but happened to be in different tax brackets.⁴¹ In *Weisenberger*, the court stated that "it would be great 'injustice' to [the] plaintiff to reduce such damages for

34. *Myzel v. Fields*, 386 F.2d 718, 742 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). "Rescission calls for cancellation of the bargain and the return of the parties to the *status quo ante*; where this is impossible because of the disposal or retirement of the stock, then the equivalent value of the stock at the time of resale . . . or at the time of judgment . . . should be the proper measure of damages." *Id.* (citations omitted).

This measure of damages is actually composed of two steps. First, the rescission is granted in order to void the contract. *Jacobs, The Measure of Damages in Rule 10b-5 Cases*, 65 GEO. L.J. 1110 (1977). Then, restitution is permitted to return the property or money taken from the plaintiff. *D. DOBBS, supra* note 2, § 4.1, at 222. *See generally* 3 H. BLACK, RESCISSION OF CONTRACTS AND CANCELLATION OF WRITTEN INSTRUMENTS § 616, at 1482 (2d ed. 1929); C. MCCORMICK, LAW OF DAMAGES § 121, at 448 (1935).

35. Note, *Securities Fraud: The Tax Benefit Offset Rule of Securities Litigation*, 70 MINN. L. REV. 1185, 1190 (1986). This is particularly true with real estate tax shelters. *See supra* note 27 (benefits realized through investments). If the rescission occurs after the first few years of the investment, it is likely that the total tax benefits realized by the defrauded investor will exceed his initial consideration paid. *See W. DROLLINGER, supra* note 10, at 21.

36. The benefit that accrues to the investor, however, will be reduced if his damage award is subject to taxation. *See infra* notes 57-60 (discussion of tax benefit rule).

37. 34 F.R.D. 482 (S.D.N.Y. 1964).

38. 35 F.R.D. 556 (S.D.N.Y. 1964).

39. For a detailed analysis and critique of these two cases, see Note, *Tax Consequences of Rescission: The Interplay Between Private and Public Law*, 42 U. CHI. L. REV. 562, 565-70 (1975).

40. 34 F.R.D. at 486. *See infra* notes 57-60 and accompanying text (discussion of tax benefit rule).

41. 34 F.R.D. at 486.

extraneous reasons wholly unconnected with the acts of [the] defendants.”⁴²

Eventually, some courts did allow discovery regarding tax benefits, in securities fraud litigation, because such information could be relevant to issues other than damages,⁴³ such as valuation of the investment,⁴⁴ misrepresentation of the potential tax benefits,⁴⁵ sophistication of the investors,⁴⁶ and reliance.⁴⁷ Finally, in the 1982 case of *Austin v. Loftsgaarden*,⁴⁸ the Eighth Circuit ruled that the tax benefit defense could be successfully asserted, in an action for tax shelter fraud, to reduce the investor’s award of rescissory damages.⁴⁹

The *Austin* court found that the tax savings generated by a real estate limited partnership was a tangible economic benefit⁵⁰ and the actual damages principle of federal securities law required that a rescissory award for fraud “be reduced by any value received as a result of the fraudulent transaction.”⁵¹ The court found that the required calculation was no more

42. 35 F.R.D. at 558. See *infra* notes 168-79 and accompanying text (discussion of collateral source rule).

43. Brief for Petitioners, *supra* note 18, at 28.

44. *Dupuy v. Dupuy*, 551 F.2d 1005, 1025 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977) (trial court properly considered tax benefits in valuing investment in closely-held corporation); *Berg v. Xerxes-Southdale Office Bldg. Co.*, 290 N.W.2d 612, 615 (Minn. 1980) (“On remand, evidence will have to be received as to the market value of the limited partnership interest, assuming the disclosure of the negative cash flow. It may well be that because of income tax considerations, the evidence will reveal that the selling price equaled the market value of the property.”).

45. *Bridgen v. Scott*, 456 F. Supp. 1048, 1062 (S.D. Tex. 1978) (“[A] plaintiff may be questioned concerning . . . tax considerations in connection with the issue of whether a misrepresentation actually occurred [A] finder of fact simply cannot understand a transaction without a basic understanding of the tax consequences.”).

46. *Smith v. Bader*, 83 F.R.D. 437, 439 (S.D.N.Y. 1979) (“The plaintiffs’ investments in other partnerships and their investments in other tax shelters may shed light on their sophistication as investors.”).

47. *Sharp v. Coopers & Lybrand*, 83 F.R.D. 343, 352 (E.D. Pa. 1979), *rev’d on other grounds*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982) (“[A]n investor’s 1971 tax return could reveal information relevant to the issue of reliance, since for example, an investor in a comparatively ‘low’ tax bracket might not have needed the type of tax shelter the defendant’s opinion letters represented these investments to be.”).

48. 675 F.2d 168 (8th Cir. 1982), *aff’d en banc*, 768 F.2d 949 (8th Cir. 1985), *cert. granted sub nom. Randall v. Loftsgaarden*, 106 S. Ct. 379 (1985) [hereinafter *Austin I*].

49. The plaintiffs in *Austin I* were investors in a real estate limited partnership explicitly marketed as a tax shelter. 675 F.2d at 173. The promoters of the investment were found guilty of violating Rule 10b-5 because they knowingly made material misrepresentations in the offering memorandum. *Id.* at 176. In addition, the district court allowed the jury’s advisory verdict which stated that the defendant was liable under section 12(2) because he “knowingly made material misrepresentations or omissions of which plaintiffs were unaware, and because there was some causal connection between the Loftsgaarden’s wrongful conduct and the plaintiffs’ purchases.” *Id.* In determining the appropriate award for damages, the Eighth Circuit ruled that the tax benefit defense should be allowed and that the plaintiffs’ recovery should be reduced by the amount of tax benefits realized. *Id.* at 183.

50. *Id.* at 180-81.

51. *Id.* at 181 (citing *Garnatz v. Stifel, Nicolaus & Co.* 559 F.2d 1357, 1361 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978)).

uncertain or complex than that already made in determining future earnings.⁵² Therefore, the Eighth Circuit held that evidence of any ongoing IRS audits and expert opinion as to the likely results would be admissible at retrial.⁵³ The jury would then determine whether and to what extent the previous deductions would be disallowed.⁵⁴

Two years later, in *Burgess v. Premier Corporation*,⁵⁵ the Ninth Circuit Court of Appeals rejected the tax benefit defense.⁵⁶ The court determined that any previous tax savings enjoyed by tax shelter investors, who received rescissionary damages, would be displaced by virtue of the tax benefit rule.⁵⁷ The tax benefit rule provided that a taxpayer who claimed a deduction in one taxable year had to recognize as income any recovery or repayment of the deduction which arose in a subsequent year.⁵⁸ Since the damages were fully taxable, the court reasoned that once the plaintiffs

52. *Id.* at 183 (citing *Norfolk & W. Ry. Co. v. Liepelt*, 444 U.S. 490 (1980)).

53. 675 F.2d at 183.

54. *Id.* The court defines a "tax shelter" as "investments which allow the investor to offset certain 'artificial losses' (that is, non-economic losses which are available as deductions under the present tax laws) not only against the income from those investments but also against the [investor's] other income, usually from his regular business or professional activity." *Id.* (quoting STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94th Cong., 1st Sess. (Comm. Print 1975)). The Eighth Circuit limited the impact of its holding in *Austin I* in *Hayden v. McDonald*, 742 F.2d 423 (8th Cir. 1984). In *Hayden*, the plaintiffs were investors who had undivided working interests in oil and gas leases located in Texas. *Id.* at 425. Suit was brought against the venture's promoter for rescission and restitution under the Minnesota Blue Sky Act for failing to register the interests as securities in the state of Minnesota. *Id.* See MINN. STAT. ANN. § 80A.23(1) (West Supp. 1984). Although the Minnesota statute used the same language as section 12(2) of the Securities Act of 1933, the court held that tax benefits realized should not reduce an award for rescissionary damages under the Minnesota law. *Id.* at 440-41. Since Minnesota courts had not interpreted the words "income received" under the Minnesota statute, the court deferred to the district court's interpretation that the phrase did not include tax benefits. However, in *Austin v. Loftsgaarden*, 768 F.2d 949 (8th Cir. 1984) [hereinafter *Austin II*], the Eighth Circuit explicitly overruled its decision in *Hayden*, even though the state issue was not presented, because the court wanted "to bring consistency" to the law. *Id.* at 953 n.6. For a discussion of the *Hayden* case, see Note, *Tax Shelter Schemes and Damages in the Eighth Circuit* — *Hayden v. McDonald*, 18 CREIGHTON L. REV. 1307 (1985).

55. 727 F.2d 826 (9th Cir. 1984).

56. *Id.* at 837-38. The plaintiffs in *Burgess* were five doctors from the Seattle, Washington area who purchased tax shelter investments in cattle herds from Premier Corporation. *Id.* at 830. The promoters were found guilty of common law fraud, negligent misrepresentation, and violating Rule 10b-5. *Id.* at 831.

57. *Id.* at 838.

58. 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.34 (rev. ed. 1986). This rule is not expressly stated in the Internal Revenue Code but is judicially created. *Id.* See, e.g., *Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370 (1983) (previous tax deduction of property taxes placed in escrow pending litigation was includable in income when the escrow amount was refunded). The Internal Revenue Code restricted the general rule by excluding recovery of previous deductions which did not reduce the income subject to taxation. I.R.C. § 111 (Supp. 1985). For a detailed discussion of the tax benefit rule, see Bittker and Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265 (1978).

paid their tax liability,⁵⁹ they would be returned to the *status quo ante*.⁶⁰ In addition, the Ninth Circuit refused to recognize the Eighth Circuit's holding in *Austin* because the government would be the "banker" for the fraudulent tax shelter activity.⁶¹

In *Salcer v. Envicon Equities, Inc.*,⁶² the Second Circuit Court of Appeals was also faced with the issue of whether rescission damages should be reduced by realized tax shelter benefits.⁶³ Both the SEC and the IRS submitted *amicus curiae* briefs which asserted that the tax benefits should not offset an award for damages.⁶⁴

The SEC's argument included three points. First, the Commission agreed with the Ninth Circuit's holding in *Burgess* that the tax benefit rule would recapture all of the previous tax benefits realized and would prevent a windfall to the plaintiffs.⁶⁵ Second, the SEC asserted that the tax savings

59. The court found that the plaintiffs would have to file amended returns for each of the tax years in which the tax benefits were realized. 727 F.2d at 838. Most practitioners find this statement to be incorrect. See, e.g., Fijolek & Banoff, *Do Tax Shelter Benefits Offset Rescission Damages? The Courts Disagree*, 5 REAL EST. SEC. J. 70, 75 (1984) ("The Ninth Circuit wrongly assumed that the 'tax benefit' rule would apply to the rescission award and would require a plaintiff to file amended tax returns for his prior tax years to remove his claimed tax losses from the rescinded investment."). Instead, income is recognized on the plaintiff's tax return for the year in which the damages are received. *Id.*

60. 727 F.2d at 838. This is the reasoning followed by the district court in *Cooper v. Hallgarten* in 1964. See *supra* notes 37-41 and accompanying text.

61. *Id.* The plaintiffs also argued that *Burgess* should be distinguished from *Austin II* because the investors in *Burgess* were motivated primarily by their desire to purchase a valuable investment in a cattle herd, with only secondary tax benefits. Brief for Plaintiffs-Appellees at 31, *Burgess v. Premier Corp.*, 727 F.2d 826 (9th Cir. 1984) (Nos. 82-3064 & 82-3090). The court, however, did not address this distinction. For additional discussion of this opinion, see Note, *Securities: Tax Shelter Investment Fraud—Should Tax Savings Be Considered in Determining Amount of Recovery?*, 38 OKLA. L. REV. 334, 341-42 (1985). The Ninth Circuit has consistently applied its holding in *Burgess* to actions brought under the federal securities laws, see *Western Fed. Corp. v. Erickson*, 739 F.2d 1439 (9th Cir. 1984), as well as its state securities statute, see *Hall v. Johnston*, 758 F.2d 421 (9th Cir. 1985) (interpreting Oregon's securities laws).

62. 744 F.2d 935 (2d Cir. 1984), *vacated and remanded*, 106 S. Ct. 3324 (1986).

63. In *Salcer*, the plaintiffs were purchasers of fifteen partnership interests in Greenpoint Associates, a tax shelter limited partnership established to construct, own, and operate a residential apartment complex. 744 F.2d at 937. Suit was brought against the promoters, under Rule 10b-5, for failing to disclose material information regarding the planned annexation of the property by the city of Houston, an event that would cause a substantial increase in building costs. *Id.* at 937-38. The defendants asserted the "tax benefit" defense but the district court refused to allow it. *Id.* at 938.

64. Brief of SEC as Amicus Curiae at 2, *Salcer v. Envicon Equities, Corp.*, 812 F.2d 713 (2d Cir. 1984) (No. 84-7183) [hereinafter *Salcer* SEC Brief]; Brief of United States as Amicus Curiae at 3, *Salcer v. Envicon Equities, Corp.*, 812 F.2d 713 (2d Cir. 1984) (No. 84-7183) [hereinafter *Salcer* IRS Brief]. The Tax Division of the Department of Justice submitted the brief on behalf of the United States Government.

65. *Salcer* SEC Brief, *supra* note 64, at 13. See *supra* notes 57-60 and accompanying text. The defendants in *Randall v. Loftsgaarden* responded to this argument by asserting that if the plaintiffs really believed they would have to pay back all of their tax benefits, it was not clear why they were bringing suit at all. See Brief For Respondents at 20, *Randall v. Loftsgaarden*,

emanated from a source collateral to the defendant.⁶⁶ Therefore, allowing the tax benefit defense would violate the common law direct product and collateral source rules which held that the plaintiffs could recover the full amount of compensatory damages from a wrongdoer even if he or she received compensation for the injury from a source entirely independent from, or collateral to, the offending party.⁶⁷ The SEC contended that the tax benefits were conferred by the government and by other income generated by the plaintiffs and not by any action taken by the defendant.⁶⁸ Third, the SEC contended that the plaintiffs would not receive a windfall if the government failed to recover all of the previous tax benefits realized because some compensation should be allowed for the use of the plaintiffs' money.⁶⁹ The SEC also argued, based on public policy, that the tax benefit defense "would discourage private enforcement of the anti-fraud provisions of the federal securities laws in an area in which the SEC itself was unable to devote substantial resources."⁷⁰

106 S. Ct. 3143 (1986) [hereinafter Brief for Respondents]. It should be noted that transactional parity is usually not realized under the tax benefit rule due to changes in the taxpayer's marginal tax rate from year to year (i.e., the tax savings on a deduction in year 1 may not equal the tax liability that arises when the deduction is recaptured in year 2). See *Hillsboro Nat'l Bank*, 460 U.S. at 376 n.12.

66. *Salcer* SEC Brief, *supra* note 64, at 12.

67. DAMAGES IN TORT ACTIONS, *supra* note 2, at 17-7. "Payments made to or benefits conferred on the injured party from other sources are not credited against the tortfeasor's liability, although they cover all or part of the harm for which the tortfeasor is liable." RESTATEMENT (SECOND) OF TORTS § 920A(2) (1979). See *infra* notes 168-79 and accompanying text (discussion of direct product and collateral source rules).

68. *Salcer* SEC Brief, *supra* note 64, at 11-12. "[T]he term 'tax shelter' is most frequently used to describe a situation in which a taxpayer generates deductions in excess of income from one activity and uses that excess to reduce income from another unrelated activity, thereby lowering the tax on the second activity." FUNDAMENTALS OF FEDERAL INCOME TAXATION, *supra* note 10, at 445. Such write-offs are restricted under the Tax Reform Act of 1986. See *supra* note 27.

69. *Salcer* SEC Brief, *supra* note 64, at 15. Courts often award prejudgment interest in securities litigation. See, e.g., *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir. 1981) (prejudgment interest allowed on damages awarded under § 16(b) of the Securities Exchange Act of 1934); *Parvin v. Davis Oil Co.*, 655 F.2d 901 (8th Cir. 1979) (prejudgment interest allowed on California securities law violation).

70. *Salcer* SEC Brief, *supra* note 64, at 2. Section 5 of the Securities Act of 1933, 15 U.S.C. § 77(e) (1982), requires the registration of all securities sales with the SEC. However, section 4(2) of the Act, 15 U.S.C. § 77(d)(2) (1982), exempts "transactions by an issuer not involving any public offering." This exemption is not defined in the 1933 Act and the legislative history provides little guidance. *Securities and Exchange Commission v. Ralston Purina, Co.*, 346 U.S. 119, 122 (1953). However, the courts have generally looked to four factors in determining whether or not a sale of stock falls outside the purview of a public offering. *Doran v. Petroleum Management Corp.*, 545 F.2d 893, 899-900 (1977). These four factors are: (1) the number of offerees and their relationship to each other and the issuer; (2) the number of units offered; (3) the size of the offering; and (4) the manner of the offering. *Id.* Tax shelter limited partnership interests are usually given exempt status from the SEC registration provisions due to this private offering exception. See R. HAFT & P. FASS, 1984 TAX SHELTERED INVESTMENTS HANDBOOK § 8

The IRS agreed with the SEC and argued that the tax benefits previously recognized by the plaintiffs would be recaptured.⁷¹ If the years were still open, i.e., still subject to assessment, the IRS could challenge the original deductions and eliminate any tax benefits.⁷² If the tax years were closed, according to the Service, the tax benefit rule required that previous benefits be picked up in income in the current year.⁷³ If the investor had already sold his tax shelter interest, other tax principles might require the recognition of income or other offsetting adjustments.⁷⁴ Lastly, the IRS stated

(1983). Consequently, the SEC argued that this exempt status makes the detection of fraud in limited partnership offerings extremely difficult and reduces the effectiveness of the Commission in enforcing the securities laws. *Salcer* SEC Brief, *supra* note 64, at 2. Therefore, private actions for securities laws violations are needed to supplement the enforcement activities of the SEC. *Id.* (citing *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 382 (1970)); *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). *See also* *Berner v. Lazzaro*, 730 F.2d 1319, 1322-23 (1979) ("The resources of the Securities Exchange Commission are adequate to prosecute only the most flagrant abuses. To this end, private actions brought by investors have long been viewed as a necessary supplement to SEC enforcement actions." (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975)), *aff'd sub nom. Bateman Eichler, Hill Richards, Inc. v. Berner* 472 U.S. 299 (1985)).

71. *Salcer* IRS Brief, note 64, at 5.

72. *Id.* Generally the IRS is given three years in which to assess taxpayers. I.R.C. § 6501(a) (1982). The statute of limitations begins to run on the due date of the return or on the date the return is actually filed, whichever is later. *Id.* § 6501(b). The courts have interpreted the word "return" to mean the original return, not a subsequently filed amended return. *See Zellerbach Paper Co. v. Helvering*, 293 U.S. 172 (1934); Rev. Rul. 72-311, 1972-1 I.R.B. 398. This three year period increases to six years if the taxpayer omits from gross income 25% or more of the amount of gross income shown on the return. I.R.C. § 6501(e) (1982). There is no statute of limitations on the assessment if the taxpayer files a false return, makes a willful attempt to evade taxes, or files no return at all. *Id.* § 6501(c)(1)-(3). In addition, the IRS and the taxpayer may extend the statute of limitations by agreement. *Id.* § 6501(c)(4). *See generally* M. GARBIS & S. STRUNTZ, *TAX PROCEDURE AND TAX FRAUD* 164-5 (1982); F. MODRICKER, W. DONALD & J. GILJUM, *STATUTE OF LIMITATIONS: INTEREST ON UNDERPAYMENTS AND OVERPAYMENTS OF TAX* (BNA) No. 28-4 (1984).

73. *Salcer* IRS Brief, *supra* note 64, at 6-7. *See supra* notes 57-61 and accompanying text (discussion of tax benefit rule).

74. *Salcer* IRS Brief, *supra* note 64, at 8 (citing *Western Fed. Corp. v. Erickson*, 739 F.2d 1439 (9th Cir. 1984)). The IRS gives three specific examples where the previous tax benefits may be subject to recapture. If the partnership interest is sold subject to debt, the investor must include the discharged indebtedness as part of the "amount realized" under I.R.C. § 1001 (1982), thereby increasing his taxable income. *Id.* *See* I.R.C. § 752(d) (1982); *Crane v. Comm'r*, 331 U.S. 1 (1947) (when property encumbered by debt is sold, the amount realized includes the discharged indebtedness); *Millar v. Comm'r*, 67 T.C. 656 (1977), *aff'd sub nom. Millar v. C.I.R.*, 577 F.2d 212 (3d Cir.) (shareholders of a tax option corporation realized taxable gain in the form of cancellation of indebtedness upon surrender of stock in the corporation), *cert. denied*, 439 U.S. 1046 (1978); *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950) (gain realized on discharge of mortgage from a bank upon reconveyance of a deed). *See generally* Adams, *Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966); Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 TAX L. REV. 277 (1978); Ginsberg, *The Leaky Tax Shelter*, 53 TAXES 719 (1975). If accelerated depreciation is taken on the partnership's assets, and these assets are sold or otherwise disposed of, all or part of any recognized gain may be subject to the depreciation recapture provisions and thus

that the tax benefits arose because Congress determined that a favorable tax treatment should be given to encourage additional investments.⁷⁵ To the extent a taxpayer was entitled to the tax benefits realized, "he, and not the [defendant] should be allowed to retain those benefits because the tax laws so provide."⁷⁶

The Second Circuit rejected the arguments of the SEC and the IRS and allowed the defendant to assert the tax benefit defense.⁷⁷ The court first noted that section 28(a) of the 1934 Act limited recovery to actual damages⁷⁸ and did not give the court discretionary power to increase that amount in order to encourage the filing of private actions.⁷⁹ The court then rejected the notion expressed by the Ninth Circuit in *Burgess* that allowing the tax benefit defense would make the government the banker for the fraudulent tax shelter activity.⁸⁰ The court reasoned that because the government received the residential development, which it had hoped to encourage by offering the tax benefits taken by the plaintiffs, it was banking precisely what it had agreed to bank.⁸¹

The Second Circuit rejected the IRS and SEC argument that the collateral source doctrine prevented the consideration of tax benefits in the determination of damages.⁸² The court found the tax benefits to be an inextricable part of the tax shelter offering which emanated directly from actions by the defendant.⁸³ The court also held that the tax benefit rule did not apply since the plaintiffs sought rescissory damages and not actual rescission.⁸⁴ The court then distinguished the *Burgess* holding. The court stated that because the investors in *Burgess* had been awarded a rescission, i.e., were returned to the *status quo ante*, they had recovered their previous deductions.⁸⁵ Therefore, the tax benefit rule applied.⁸⁶ Since the plaintiffs in *Salcer*, however, sought rescissory damages, a purely monetary award,

given ordinary income treatment. *Salcer* IRS Brief at 8-9. The depreciation recapture provisions of I.R.C. section 1250 (1982) generally apply to real estate. See generally FUNDAMENTALS OF FEDERAL INCOME TAXATION, *supra* note 10, at 818-32. Lastly, the IRS notes that the sale of some partnership assets may also trigger the recapture of the investment credit. *Salcer* IRS Brief, *supra* note 64, at 9. See generally FUNDAMENTALS OF FEDERAL INCOME TAXATION, *supra* note 10, at 830-31. Both capital gains and the investment credit have been repealed under the Tax Reform Act of 1986.

75. *Salcer* IRS Brief, *supra* note 64, at 9-10.

76. *Id.* at 10.

77. 744 F.2d at 939-40.

78. *Id.* at 940. See text of statute, *supra* note 21.

79. 744 F.2d at 941 (citing *Alaska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240 (1975)).

80. 744 F.2d at 941. See *supra* note 64 and accompanying text.

81. 744 F.2d at 941.

82. *Id.* at 941-42.

83. *Id.*

84. *Id.* at 943.

85. *Id.*

86. *Id.* See *supra* notes 57-60 and accompanying text (discussion of tax benefit rule).

they were not returned to the *status quo ante*.⁸⁷ Therefore, they did not recover their prior deductions and the tax benefit rule did not apply.⁸⁸

Due to the conflict among the circuit courts, lower court decisions have been equally divergent.⁸⁹ When the Supreme Court granted the plaintiffs' petition for certiorari in *Randall*,⁹⁰ it was hoped that many of the unsettled issues would be resolved, such as whether the actual damages provisions under federal securities laws required that damages be reduced by economic benefits received or merely income received, whether the tax benefit rule required recognizing as income a rescissionary damage award for recovery from a fraudulent tax shelter scheme,⁹¹ and whether the collateral source or direct product doctrine should apply to such awards.

II. THE RANDALL DECISION

In 1973, the four plaintiffs, along with eighteen other investors,⁹² purchased interests in Alotel Associates, a limited partnership organized to construct and manage a Ramada Inn motel in Rochester, Minnesota.⁹³ Defendant B.J. Loftsgaarden, president and sole shareholder of defendant Alotel, Inc., organized the venture and was to serve as a general partner along with the corporation.⁹⁴

The original offering memorandum stated that the limited partnership would utilize financing techniques that would generate substantial tax benefits during the initial years of the venture and would generate profits

87. 744 F.2d at 943.

88. *Id.* The court responded to the third argument asserted by the SEC, regarding prejudgment interest, by stating that the tax benefits realized by the investors were so disproportionate to any computation of prejudgment interest that an argument that they should be treated equivalently bordered on the frivolous. *Id.* at 942. For additional discussion of this opinion, see Note, *Tax Benefits in Mitigation of Rule 10b-5 Damages: William Z. Salcer v. Envicor Equities Corp.*, 21 TULSA L.J. 542 (1986). The Second Circuit reaffirmed its holding in *Salcer* in *Freschi v. Grand Coal Venture*, 767 F.2d 1041 (2d Cir. 1985), *vacated and remanded*, 106 S. Ct. 3324 (1986) (marketing of fraudulent coal leases as tax shelters).

89. See *supra* notes 15 & 16.

90. 106 S. Ct. 379 (1985).

91. Recent articles by tax practitioners recognize the uncertainty regarding the tax consequences of these awards. See, e.g., Banoff, *Unwinding or Rescinding A Transaction: Good Tax Planning or Tax Fraud?*, 62 TAXES 972 (1984) ("[T]he tax consequences of the rescission award for a tax shelter interest are not certain."); McCauley, *Rescissionary Awards For Securities Fraud-The Tax Benefit Defense Does Not Work*, 64 TAXES 250-51 (1986) ("It may be said that the successful development of the tax benefit defense is attributable to the uncertainty relative to the proper tax treatment of rescissionary awards.").

92. *Austin v. Loftsgaarden*, 675 F.2d 168, 172 (8th Cir. 1982).

93. See Brief for Petitioners, *supra* note 18, at 13.

94. *Randall v. Loftsgaarden*, 106 S. Ct. 3134, 3146 (1986). Property Development and Research Company and 2361 Building Corporation were also named as defendants. Brief for Respondents, *supra* note 65, at 5 n.4. Property Development and Research Corporation was to acquire the property for the venture while 2361 Building Corporation was to act as general contractor for the project. *Id.*

in the later years.⁹⁵ The project was to be financed through the use of a nonrecourse note which would support the accelerated depreciation methods that generated the partnership's tax losses.⁹⁶ Alotel Associates experienced financial difficulties from the outset, and in February 1975, Loftsgaarden solicited the investors to extend additional advances to the partnership.⁹⁷ The subsequent loans, however, proved insufficient. Thus, the partnership defaulted on its obligations and the mortgage lender foreclosed on the motel.⁹⁸

In 1976, the plaintiffs brought suit in federal district court for securities fraud and asserted federal claims under section 12(2) of the 1933 Act, section 10b of the 1934 Act, and SEC Rule 10b-5, as well as pendent state law claims.⁹⁹ The jury found that Loftsgaarden had knowingly made material misrepresentations and omissions in the offering memorandum, upon which the investors relied, thereby causing their damages.¹⁰⁰ Consequently, the defendant was liable under section 10(b), Rule 10b-5, and state law.¹⁰¹ In addition, the district court also accepted the jury's advisory verdict that the defendant was liable under section 12(2).¹⁰² The trial court held that rescission was the proper award for damages under section 12(2) and awarded the plaintiffs the amount of the consideration paid for the investment, plus prejudgment interest.¹⁰³ The court rejected Loftsgaarden's argument that the plaintiffs' recovery should be reduced by tax benefits realized and stated that it wanted to avoid complex tax testimony.¹⁰⁴ It dismissed the defendant's contention as "sophistic malarkey."¹⁰⁵

The defendant's liability under the state and federal securities laws was affirmed on appeal by the Court of Appeals for the Eighth Circuit.¹⁰⁶ However, the court of appeals ruled that the lower court was incorrect in refusing to offset the damage award by the amount of the tax benefits realized on the plaintiffs' investment.¹⁰⁷ The Eighth Circuit found that tax

95. *Austin II*, 768 F.2d 949, 951 (1985). The original offering proved unsuccessful. Consequently, Loftsgaarden revised the memorandum and proposed that the land be rented rather than purchased since this would generate another deductible expense. 106 S. Ct. at 3147. The plaintiffs subscribed to this revised offering with investments from \$35,000 to \$52,000 per person. *Id.*

96. 106 S. Ct. at 3147.

97. *Id.*

98. *Id.* The foreclosure proceedings can be found in *United Realty Trust v. Property Dev. & Research Co.*, 269 N.W.2d 737 (Minn. 1978).

99. 106 S. Ct. at 3147. For text of federal statutes, see *supra* notes 20-21, & 29.

100. 106 S. Ct. at 3147. The misstatements included mischaracterizing the financial resources available, the terms of the land lease, and details concerning the defendants' compensation. *Id.*

101. *Id.*

102. *Id.*

103. *Id.* The court ruled that rescission was allowed even though the investors had not attempted to return their limited partnership interests until shortly before trial. *Id.*

104. *Id.*

105. *Id.* See *Austin I*, 675 F.2d 168, 181 (8th Cir. 1982).

106. 675 F.2d 168.

107. *Id.* at 183-84.

deductions had a real economic value.¹⁰⁸ Consequently, the “strictly compensatory nature” of damage awards under the securities laws required that this value be considered in evaluating “whether and to what extent damages were inflicted upon [the] plaintiffs.”¹⁰⁹

The court recognized that permitting evidence regarding tax matters would increase the complexity of trial proceedings but that such matters were neither too complicated nor too speculative for jury consideration.¹¹⁰ To limit the impact of its decision, the court restricted its holding “only to those cases involving investments that are expressly marketed and sold as tax shelters.”¹¹¹

On remand, the district court calculated damages in accordance with the Eighth Circuit’s holding.¹¹² On appeal, the Eighth Circuit reconsidered the case en banc.¹¹³ The court of appeals upheld its original ruling and found that although the “actual damages” language of section 28(a) of the 1934 Act did not appear anywhere in the 1933 Act, the courts have consistently interpreted the provisions of the 1933 legislation as limiting recovery to actual damages.¹¹⁴ In addition, the court recognized that while tax benefits realized were not “a form of income in the strict accounting sense,” they should be treated as income received under section 12(2) so that the goal of rescission, returning the parties to the *status quo ante*, could be realized.¹¹⁵ Two judges dissented, stating that the amount of tax savings was not income received. Rather, it represented only a tax deferral subject to recapture at a later date.¹¹⁶ The dissenters also stated that the majority’s interpretation of the statute provided “a windfall to the defendant—the fraudulent party.”¹¹⁷ The plaintiffs then appealed the court’s decision.¹¹⁸

The SEC and the Department of Justice filed a joint *amicus curiae* brief, on behalf of the IRS with the United States Supreme Court. The government agencies again asserted the direct product or collateral source rule as

108. *Id.* at 182-83. “[U]nlike a corporate shareholder, . . . even if the enterprise fails to become profitable, the limited partners clearly may have something of value due to the investment’s unique tax treatment.” *Id.* at 182.

109. *Id.* at 183. The court referred to this notion as the “actual damages principle.” *Id.* at 181.

110. *Id.* at 183.

111. *Id.*

112. 106 S. Ct. at 3148. The district court computed each investor’s damages as the price paid for his investment plus simple interest less tax benefits realized. *Id.*

113. *Austin II*, 768 F.2d 949 (8th Cir. 1985).

114. *Id.* at 954. The court cited *Globus v. Law Research Serv.*, 418 F.2d 1276, 1278, 1283-86 (2d Cir. 1969) (section 28(a) applied to bar punitive damages under section 17(a) of the 1933 Act), *cert. denied*, 397 U.S. 913 (1970).

115. 768 F.2d at 954-55.

116. *Id.* at 963 (Lay, C.J., dissenting). See *supra* notes 71-74 (IRS position that the tax benefits would be recaptured).

117. 768 F.2d at 963.

118. The petition for a Writ of Certiorari was filed on September 24, 1985, and was granted on November 12, 1985. Brief for Petitioners, *supra* note 18, at 1.

an argument against the tax benefit defense.¹¹⁹ They argued that the right to a tax deduction had no economic value "in and of itself," but was only valuable when used to offset the investors' other income.¹²⁰ Therefore, the tax benefits were not a direct product of the investment because, for such benefits to be realized, they required "the intervention of an independent transaction by the possessor."¹²¹

The *amici* brief also asserted the position of the *Burgess* court that the tax benefit rule would serve to reduce or eliminate any tax benefits realized by the plaintiffs.¹²² In addition, the government agencies argued that the Eighth Circuit's holding was confusing because it was only limited to "tax shelter" investments and it was difficult to determine which tax preferred investments qualified as "shelters."¹²³ Lastly, the *amici* brief argued that when an action for securities fraud was brought, the investors' relevant tax returns were often under audit so that previous tax deductions or credits might be disallowed.¹²⁴ Therefore, determining the tax benefits retained by the plaintiffs "will be wholly speculative, and any effort to offset the damage award thereby will lapse into a tailspin of circular reasoning."¹²⁵

In an eight to one decision, the Supreme Court reversed the holding of the Eighth Circuit Court of Appeals.¹²⁶ In an opinion written by Justice O'Connor, the Court first examined the language of section 12(2) to construe the meaning of the term income received.¹²⁷ The Court found that the receipt of tax deductions or credits was not taxable under the Internal Revenue Code¹²⁸ and that such benefits could not reasonably be defined as

119. Brief of Amici Curiae, *supra* note 27, at 12-14. See *supra* notes 66-68 and accompanying text (SEC position regarding the collateral source rule in *Salcer*); *infra* notes 168-79 and accompanying text (discussion of direct product and collateral source rules).

120. Brief of Amici Curiae, *supra* note 27, at 13.

121. *Id.* (quoting RESTATEMENT OF RESTITUTION § 157 comment b (1937)).

122. Brief of Amici Curiae, *supra* note 27, at 22-27. See *supra* notes 57-60 and accompanying text (discussion of tax benefit rule).

123. Brief of Amici Curiae, *supra* note 27, at 27-28.

124. *Id.* at 29.

125. *Id.*

126. 106 S. Ct. 3143 (1986).

127. *Id.* at 3150 (citing *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977)). See text of section 12(2), *supra* note 20.

128. 106 S. Ct. at 3150 (referring to I.R.C. § 61 (1982)).

GENERAL DEFINITION — Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, fringe benefits, and similar items; (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends; (8) Alimony & separate maintenance payments; (9) Annuities; (10) Income from life insurance and endowment contracts; (11) Pensions; (12) Income from discharge of indebtedness; (13) Distributive share of partnership gross income; (14) Income in respect of a decedent; and (15) Income from an interest in an estate or trust.

I.R.C. § 61(a).

income.¹²⁹ Therefore, the damages award should not be offset by the tax benefits realized.¹³⁰

The Court then stated that even at common law, tax benefits would not be considered in computing a rescissory remedy due to the direct product or collateral source rule.¹³¹ The Court agreed with the SEC and the IRS¹³² and held that tax benefits were probably not a direct product of the security since they were only realized if the deductions or credits generated by the investment offset the investors' other income or their total tax liability.¹³³

The Court then interpreted the meaning of actual damages under section 28(a).¹³⁴ The Court examined the law at the time section 28(a) was enacted¹³⁵ and found that section 12(2) stood as "a conspicuous example of a rescissory remedy" and that such damages should not be reduced by realized tax benefits.¹³⁶ Therefore, the Court held that section 28(a) required the same result where rescissory damages were obtained under section 10(b).¹³⁷

The majority also stated that refusing to reduce the damage award by the tax benefits realized prevented the unjust enrichment of the defendant, an alternative goal of the securities laws.¹³⁸ The Court reasoned that even if the tax benefits could be characterized as a windfall, the tax benefit rule would probably make the recovery taxable, and would substantially reduce the windfall.¹³⁹ The Court maintained that its holding was consistent with the congressional intent to deter fraud and "manipulative practices in the securities markets," and would ensure "full disclosure of information

129. 106 S. Ct. at 3150.

130. *Id.* The majority also rejects the defendants' contention that tax benefits constitute consideration under section 12(2) and therefore should be used in a determination of damages to offset the initial consideration paid by the investor. *Id.* at 3151-52 (citing Brief for Respondents, *supra* note 65, at 29-30). The Court states that within the context of the statute, the word "consideration" means only "the money or property given by the investor in exchange for a the security." *Id.* Thus tax benefits are not included. *Id.*

131. 106 S. Ct. at 3151. *See infra* notes 168-79 and accompanying text (discussion of direct product and collateral source rules).

132. *See* Brief of Amici Curiae, *supra* note 27, at 9-14.

133. 106 S. Ct. at 3151.

134. *Id.* at 3153. *See supra* note 21 (text of statute).

135. 106 S. Ct. at 3153 (citing *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 378 (1982)).

136. 106 S. Ct. at 3153.

137. *Id.*

138. *Id.* (citing *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965)). *See infra* note 194 and accompanying text; *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) ("Where the defendant received more than the seller's actual loss, . . . damages are the amount of the defendant's profit."). *See generally* Thompson, *supra* note 33.

139. 106 S. Ct. at 3154. "We are told that the 'tax benefit rule' will apply in cases of rescission, thus making the recovery taxable as ordinary income." *Id.* (citing *Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370 (1983)); Brief of Amici Curiae, *supra* note 27, at 25. The Court went on to say that "[a]ny residual gains to plaintiffs thus emerge more as a function of the operation of the Internal Revenue Code's complex provisions than of any unduly generous damages standard for defrauded investors." 106 S. Ct. at 3154.

material to investment decisions."¹⁴⁰ Permitting an offset of tax benefits would insure that those found guilty of securities fraud would effectively be protected from substantial liability for civil damages.¹⁴¹

The majority then concluded that section 28(a) did not require a complete investigation of the investors' tax status to determine their damages.¹⁴² The Court also dismissed the defendant's argument that failing to recognize an offset ignored "the economic reality of the tax benefits produced by tax shelters."¹⁴³ The Court stated that "[i]t is for Congress, not this Court, to decide whether the federal securities laws should be modified to comport with respondents' version of economic reality."¹⁴⁴

Justice Blackmun, in a concurring opinion, stated that in an action brought solely under section 10(b) and Rule 10b-5 it might be proper to take tax benefits into account.¹⁴⁵ As stated previously, the normal measure of damages under section 10(b) is the investor's "out-of-pocket" loss.¹⁴⁶ Justice Blackmun noted that an investor who received "the promised tax benefits, but not the promised income stream or appreciation," had been injured.¹⁴⁷ However, the injury did not extend to the tax benefits received because the investor retained the benefit of his bargain.¹⁴⁸ Therefore, under

140. 106 S. Ct. at 3154 (citing *Affiliated Ute Citizens*, 406 U.S. at 151; *Herman v. Huddleston*, 459 U.S. 375, 386-87 (1983)). See Preamble to the 1933 Securities Act, *supra* note 22.

141. 106 S. Ct. at 3154.

142. *Id.* "It is enough that there are formidable difficulties in predicting the ultimate treatment of the investor's claimed tax benefits, whether or not an audit has been commenced, and that the burdens associated with reconstruction of the investor's tax history for purposes of calculating interest are substantial." *Id.*

143. *Id.* (citing Brief of Respondents, *supra* note 65, at 14). Loftsgaarden argues that the SEC recognizes the materiality of these tax benefits in SEC Industry Guide No. 5, *Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships*, which "requires inclusion of opinions on a variety of tax issues relating to limited partnerships, with an emphasis on the risks that anticipated tax benefits will be lost through failure to meet formal requirements or through economic events." Fed. Sec. L. Rep. (CCH) 3829, 3338-39, 3342-45 (May 24, 1982). Brief of Respondents, *supra* note 65, at 13 n.9.

144. 106 S. Ct. at 3155.

145. The petitioners in *Randall* prevailed on their section 12(2) claim as well as their section 10(b) claim and could therefore select the more favorable damages remedy. *Randall v. Loftsgaarden*, 106 S. Ct. 3143, 3156 (1986) (Blackmun, J., concurring). A plaintiff's options may be limited, however, due to the relatively short statute of limitations period that applies to actions brought under section 12(2). H. BLUMENTHAL, *SECURITIES LAW HANDBOOK* § 11.09, at 296 (1986). Such actions "must be brought within one year after the discovery of the untrue statement, or after it should have been discovered, but in no event after three years from the date of sale." *Id.* Under Rule 10b-5, the courts look to the appropriate state statute of limitations. See *Holmberg v. Armbricht*, 327 U.S. 392, 395 (1946) (where Congress fails to provide a limitation period for an action, the established federal policy is to follow the local statute of limitations). Therefore, in those cases where the statute of limitations is longer and the limitation period under section 12(2) has run, the plaintiff can only seek relief under section 10(b).

146. 106 S. Ct. at 3156. See *supra* note 31 and accompanying text (discussion of out-of-pocket loss).

147. 106 S. Ct. at 3157.

148. *Id.*

an out-of-pocket loss measure, the damages should not include any payment made by the investor for these tax benefits.¹⁴⁹

Justice Brennan, the lone dissenter, stated that he would "look for guidance in interpreting the word 'income' in the theory and goals of common law rescission and equitable restitution, rather than in the Internal Revenue Code, as the [majority] does."¹⁵⁰ Brennan stated that if the plaintiffs could recover the full consideration they gave, pursuant to the agreement, and retain the benefits conveyed to them by the defendant, they would be better off economically than they were before the contract was made, contrary to the goal of restitution.¹⁵¹ Justice Brennan then concluded that the majority's interpretation of the word "income" ignored reality because it excluded valuable tax benefits.¹⁵²

III. ANALYSIS AND IMPACT

By failing to consider the tax aspects of the plaintiffs' tax shelter investment as well as the subsequent rescission of the agreement, the Court in *Randall* takes an unrealistic approach to the determination of damages under the federal securities laws. The Court avoids a discussion of the tax aspects of the transaction by narrowly interpreting key terms under the federal statutes and misapplying the collateral source and direct product rules. Consequently, courts may now effectively award the plaintiff-investor with a windfall unintended by the federal securities statutes. Although this may deter fraud in the securities marketplace,¹⁵³ it is at odds with the goal of rescission which is to return the parties to the *status quo ante*. If Congress intended the deterrence of fraud to be a primary goal of the federal securities civil liability provisions, it should have provided for a harsher form of damages.¹⁵⁴

149. *Id.*

150. *Id.* at 3157 (Brennan, J., dissenting). See *supra* notes 32-34 and accompanying text (discussion of rescission and restitution). Justice Brennan notes that income is commonly defined as "a gain or recurrent benefit usually measured in money that derives from capital or labor," and that this could encompass tax savings. 106 S. Ct. at 3158-59 (citing Webster's Ninth New Collegiate Dictionary 610 (1983)).

151. 106 S. Ct. at 3158.

152. *Id.* at 3158-59.

153. According to one Securities and Exchange Commissioner, Joseph Grundfest, deterring fraud in the securities marketplace is the primary reason for not allowing the tax benefit defense. In a recent address to the Southern Securities Institute in Miami entitled *Should Taxpayers Subsidize the Perfect Fraud? A Closer Look at Randall v. Loftsgaarden and the 'Tax-Offset Rule'*, Mr. Grundfest stated that the Second and Eighth Circuits have "brought the perfect fraud closer to reality." Address by Joseph Grundfest, Sixth Annual Southern Securities Institute (Feb. 14, 1986), portions reprinted in 18 Sec. Reg. & L. Rep. (BNA) No. 8, at 256 (1986). He stated that "[e]ven if investors discover fraud and file an ironclad complaint, the fraudulent seller has no reason to fear a civil damage award under the federal securities laws because he will never be forced to disgorge the proceeds of his fraud." *Id.*

154. The courts have consistently held that punitive damages are not authorized under the

In most cases, the investor's damages should not be reduced by the full amount of the tax benefits realized due to the tax treatment of the damage award.¹⁵⁵ However, by holding that the tax benefits received should not even be considered in determining rescissory damages, the Court not only allows for an inaccurate attempt to return the investor to the *status quo ante*, but provides Congress and the IRS with no incentive to end the confusion surrounding the tax treatment of such awards.¹⁵⁶

A. Income Received

The term income received is not defined in either the Securities Act of 1933 or the Securities and Exchange Act of 1934.¹⁵⁷ The plaintiffs in *Randall* contend that income has a "well settled" meaning, citing section 61 of the Internal Revenue Code.¹⁵⁸ The Supreme Court is quick to accept this definition for income received under section 12(2) of the 1933 Act.¹⁵⁹ In the business context, however, income has many meanings. For example, there is accrual income,¹⁶⁰ taxable income,¹⁶¹ and cash

federal securities laws. See, e.g., *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1286 (2d Cir. 1969) (neither the 1933 Act nor the 1934 Act allow punitive damages), *cert. denied*, 397 U.S. 913 (1970). In some circumstances, however, an investor may recover punitive damages if he combines his federal securities law claim with a common law fraud claim. See *Coffee v. Permia Corp.*, 474 F.2d 1040 (5th Cir. 1973); *infra* note 191 and accompanying text (discussion of punitive damages).

155. See *infra* notes 213-16 and accompanying text.

156. See *infra* notes 217-22 and accompanying text. This is ironic in light of the fact that the Supreme Court agreed to hear *Randall v. Loftsgaarden* because of "its importance to the administration of the federal tax and securities laws." 106 S. Ct. at 3149.

157. See Brief of Amici Curiae, *supra* note 27, at 16. "Congress did not specify, either in the text of the statute or in its legislative history, what constitutes 'income received' . . . on a security for purposes of section 12(2)."

158. Brief of Petitioners, *supra* note 18, at 17. See *supra* note 128 (text of I.R.C. § 61 (1982)).

159. 106 S. Ct. at 3150. "Unlike payments in cash or property received by virtue of ownership of a security — such as distributions or dividends on stock, interest on bonds, or a limited partner's distributive share of the partnership's capital gains or profits — the 'receipt' of tax deductions or credits is not itself a taxable event, for the investor has received no money or other 'income' within the meaning of the Internal Revenue Code" (citing I.R.C. § 61 (1982)).

160. Under the accrual basis of accounting, "[r]evenue is recognized when it is realized and expenses are recognized when incurred, without regard to the time of the receipt or payment." W. MEIGS, A. MOSICH & C. JOHNSON, *INTERMEDIATE ACCOUNTING* 23 (4th ed. 1978).

161. INDIVIDUALS - For purposes of this subtitle, in the case of an individual, the term "taxable income" means adjusted gross income (defined by I.R.C. § 62 (1982)) —

1. reduced by the sum of E
 - a. the excess itemized exemptions, E
 - b. the deductions for personal deductions, provided by section 151, and
 - c. the direct charitable deduction, and
2. increased (in the case of an individual for whom an unused zero bracket amount computation is provided by subsection (e)) by the unused zero bracket amount (if

income,¹⁶² to name but a few.¹⁶³ Without justification, the Supreme Court chooses to define income as gross income under section 61 of the Internal Revenue Code which does not include tax benefits realized.¹⁶⁴

The Court easily could have used net income as defined by Generally Accepted Accounting Principles (GAAP).¹⁶⁵ According to Opinion No. 11 of the Accounting Principles Board,¹⁶⁶ tax benefits associated with losses are recognized currently as an increase to net income to the extent realization is assured.¹⁶⁷ Since a tax shelter investor recognizes a current tax benefit (one of his primary motivations for making the investment), this benefit could reasonably be characterized as income which is recognizable under section 12(2).

B. The Collateral Source and Direct Product Rules

The collateral source rule attempts to maintain a balance between two well established principles of the common law.¹⁶⁸ First, with the exception of punitive damages, it is generally agreed that the plaintiff should recover no more than the actual loss he sustained.¹⁶⁹ Second, the defendant should

any).

I.R.C. § 63(b) (1982).

162. "Under the cash basis of accounting, revenue is recognized only when cash is received; expenses are recorded when they are paid in cash." W. MEIGS, A. MOSICH & C. JOHNSON, *supra* note 160, at 24.

163. See *supra* note 150 and accompanying text (Justice Brennan's definition of income). See also BLACK'S LAW DICTIONARY 687-88 (5th ed. 1979) (additional types of income, e.g., earned income, imputed income, operating income, etc.).

164. 106 S. Ct. at 3150. See *supra* note 128 (text of I.R.C. § 61 (1982)).

165. "Although a body of generally accepted accounting principles has long been recognized by business executives, courts, and governmental agencies, as well as by professional accountants, no complete official list of such accounting principles exists." W. MEIGS, A. MOSICH & C. JOHNSON, *supra* note 160, at 12. "The most authoritative sources of generally accepted accounting principles in recent years have been the *Statements* issued by the FASB (Financial Accounting Standards Board), the *Opinions* issued by the APB (Accounting Principles Board), the *Accounting Research Bulletins* issued by the AICPA (American Institute of Certified Public Accountants) Committee on Accounting Procedure, and *Accounting Series Releases* issued by the SEC." *Id.* APB Accounting Principles - Current Text §§ 1021-29 (cited in E. FARIS, ACCOUNTING FOR LAWYERS 43 (3d ed. 1975)) defines net income (net loss) as "the excess (deficit) of revenue over expenses for an accounting period which is the net increase (net decrease) in owners' equity (assets minus liabilities) of an enterprise for an accounting period, from profit-directed activities that is recognized and measured in conformity with generally accepted accounting principles."

166. See *supra* note 165 (definition of APB).

167. "When an operating loss occurs following a period of profitable operations, a corporation has a claim for a refund of past income taxes that should be recognized in the accounting records in the year in which the loss occurs." W. MEIGS, A. MOSICH & C. JOHNSON, *supra* note 160 at 864. See generally FASB Research Report, *Accounting For Income Taxes: A Review of Alternatives* 95-107 (1983).

168. DAMAGES IN TORT ACTIONS, *supra* note 2, at 17-6.

169. *Id.* See, e.g., *Hudson v. Lazarus*, 217 F.2d 344, 346 (D.C. Cir. 1954) ("In general the law seeks to award compensation, and no more, for personal injuries negligently inflicted.");

be held accountable for all the losses he has inflicted.¹⁷⁰ When an independent source of compensation for the plaintiff, such as insurance arises, one of these principles will be violated.¹⁷¹ The court must decide whether to ignore the independent compensation in computing the damages and allow the plaintiff to receive more than his actual loss, or offset the damage award by the amount of the independent compensation and hold the defendant responsible for less than the damages he proximately caused.¹⁷² The collateral source rule adheres to the former view because tort damages are not reduced by collateral benefits received by the plaintiff, even if such benefits totally eliminate the plaintiff's loss.¹⁷³

Two rationales support the collateral source rule.¹⁷⁴ First, the defendant should not be given the benefit of compensation which is obtained by the plaintiff from an entirely independent source.¹⁷⁵ Second, the plaintiff usually contracts for the benefits (e.g., insurance) and should not be penalized for having the foresight to protect himself against future losses.¹⁷⁶ For the doctrine to apply, it is important to note that the source of compensation

Hanna v. Martin, 49 So. 2d 585, 587 (Fla. 1950) ("The fundamental principle of the law of damages is that the person injured by breach of contract or by wrongful or negligent act or omission shall have fair and just compensation commensurate with the loss sustained in consequence of the defendant's act which give rise to the action. In other words, the damages awarded should be equal to and precisely commensurate with the injury sustained.").

170. "The courts were interested primarily in keeping the peace between individuals by providing a substitute for private vengeance, and the party injured was just as likely to take the law into his own hands when the injury was an innocent one. The man who hurt another by pure accident or in self-defense was required to make good the damages he inflicted." W. PROSSER, J. WADE & V. SCHWARTZ, TORTS 1 (1982).

171. Other possible independent sources of compensation include unemployment benefits, gratuities, and social legislation benefits. Maxwell, *The Collateral Source Rule in the American Law of Damages*, 46 MINN. L. REV. 669 (1962).

172. DAMAGES IN TORT ACTIONS, *supra* note 2, at 17-6.

173. Fleming, *The Collateral Source Rule and Loss Allocation in Tort Law*, 54 CALIF. L. REV. 1478 (1966). See *supra* notes 66-68, 119-21, & 131-33 (discussion of the direct product and collateral source rules).

174. Overton v. United States, 619 F.2d 1299, 1306 (8th Cir. 1980).

175. *Id.* at 1306 ("[T]he wrongdoer does not deserve to benefit from the fortuity that the plaintiff has received or will receive compensation from a source wholly independent of the wrongdoer."); Hudson v. Lazarus, 217 F.2d 344, 346 (D.C. Cir. 1954) ("Usually the collateral contribution necessarily benefits either the injured person or the wrongdoer. Whether it is a gift or a product of the contract of employment or of insurance, the purposes of the parties to it are obviously better served and the interests of society are likely to be better served if the injured person is benefited than if the wrongdoer is benefited.").

176. See, e.g., Feeley v. United States, 337 F.2d 924, 928 (3d Cir. 1964) ("[O]ne can justify a double recovery where the original source was supplied by the plaintiff, himself, out of resources that would otherwise have been available to him for other purposes."); Note, *Unreason in the Law of Damages: The Collateral Source Rule*, 77 HARV. L. REV. 741, 748-52 (1964) (where the collateral payment is a gift, the donee should receive the intended benefit, not the defendant; determining collateral benefits may be too speculative; legal compensation for personal injuries does not fully compensate).

must be collateral, i.e., secured from someone other than the defendant.¹⁷⁷ Otherwise, the plaintiff would receive more than his actual loss and the defendant would be forced to pay more than the amount of the damages he actually caused.¹⁷⁸ The equivalent concept under the law of restitution is the direct product rule, in which the plaintiff is required to credit the defendant with gains that are the direct product of, that is, not collateral to, the consideration received by the plaintiff in the transaction to be rescinded.¹⁷⁹

The Supreme Court, in *Randall*, agreed with the SEC that the tax benefits realized should be ignored under the direct product rule.¹⁸⁰ The Court argued that the tax benefits were not a direct product of the tax shelter investment because they were only of value when combined with other income or additional tax liability of the plaintiff.¹⁸¹ This argument, however, ignored the fact that the tax benefits were not only a direct product of the investment agreement, but were the primary focus of the agreement.¹⁸² The initial tax benefits were realized due to the defendant's direct and intentional efforts in building a motel and syndicating a limited partnership in accordance with the provisions of the Internal Revenue Code.¹⁸³ In addition, the defendant increased the benefits by obtaining sufficient loans to pay for the deductions taken.¹⁸⁴ These efforts were not less direct merely because the parties assumed that the investor would generate other income that would be sheltered by the tax losses or credits.¹⁸⁵ These tax

177. See *Adams v. Turner*, 238 F. Supp. 643, 644-45 (D.D.C. 1965) ("[The collateral source rule] does not apply in a situation where the collateral source is the defendant himself. Under those circumstances no one gets a windfall and if a recovery were allowed under those circumstances the result would be that the plaintiff would receive a double recovery and that the defendant would be mulcted twice for the same item of damages.")

178. *Id.*

179. *Randall v. Loftsgaarden*, 106 S. Ct. 3143, 3151 (1986) (citing RESTATEMENT OF RESTITUTION § 157 comment b (1937)).

180. *Id.* See *supra* notes 119-21 and accompanying text (discussion of arguments set forth in amici curiae brief).

181. *Id.* See *supra* notes 131-33 and accompanying text (argument set forth by the court regarding the direct product rule).

182. "One of the prime motivations for investment in limited real estate partnerships is the unique tax advantage made available to high tax bracket individuals." *Salcer v. Envicon Equities*, 744 F.2d 935, 940 (2d Cir. 1984). See *supra* note 27 (discussion of tax shelter investments).

183. Brief of Respondents, *supra* note 65, at 22.

184. *Id.* See *supra* note 27 and accompanying text (discussion of at risk provisions). The respondents obtained these funds exclusively through their own efforts. Alotel Associates' expenditure of these funds were three times the amount the investors advanced and resulted in tax benefits three times greater than what would have received without the loans. Brief of Respondents, *supra* note 65, at 22.

185. In an unnumbered footnote in his dissent, Justice Brennan equates a tax shelter with a rebuilt automobile engine. *Randall v. Loftsgaarden*, 106 S. Ct. 3143, 3159 (1986) (Brennan, J., dissenting). "We do not—at least I would not—describe the value that an engine has when placed in a car as 'indirect' simply because the buyer had to acquire a car in order to exploit that value." *Id.* The defendants supported their position with a different analogy. Brief for

benefits were bargained for and the benefits were as much a part of the transaction as the expected profits.¹⁸⁶ Therefore, the direct product and collateral source rules should not exclude the tax benefits realized from the computation of damages.

C. Actual Damages

Rather than looking to the "language of the statute itself" as the Court did in interpreting "income" under section 12(2) of the 1933 Act,¹⁸⁷ the *Randall* Court examined "the state of the law at the time the legislation was enacted" to interpret actual damages under section 28 of the 1934 Act.¹⁸⁸ This is odd because income does not have a fixed definition,¹⁸⁹ whereas the courts have consistently interpreted actual damages to mean compensatory damages or net economic loss¹⁹⁰ such that punitive damages are clearly excluded.¹⁹¹ Thus, there is an even stronger argument to examine

Respondents, *supra* note 65, at 24. "Suppose that Alotel Associates took the petitioners' funds and purchased certificates of deposit from a bank. Suppose further that Alotel Associates then distributed all those certificates to the petitioners, who promptly took them to the bank and received payments equaling their investments. Meanwhile, their partnership interests became worthless and they commenced an action for fraud. It would be unthinkable that they could recover under these circumstances simply because the payments they received ultimately came from a bank rather than Alotel Associates." *Id.*

186. See Note, *supra* note 39, at 567.

187. 106 S. Ct. at 3150. See *supra* notes 127-30 and accompanying text (summary of the Court's discussion of income received).

188. 106 S. Ct. at 3152. See *supra* notes 134-37 and accompanying text (summary of the Court's discussion of actual damages).

189. See *supra* notes 157-67 and accompanying text (discussion of income received).

190. See, e.g., *Birdsall v. Coolidge*, 93 U.S. 64, 64 (1876) ("Compensatory damages and actual damages mean the same thing; that is, the damages will be the result of injury alleged and proved, and that the amount awarded will be precisely commensurate with the injury suffered, neither more nor less, whether the injury be to the person or the estate of the complaining party."); *Osofsky v. Zipf*, 645 F.2d 107, 111 (2d Cir. 1981) ("[W]e believe that the purpose of section 28(a) is to compensate civil plaintiffs for economic loss suffered as a result of wrongs committed in violation of the 1934 Act, whether the measure of those compensatory damages be out-of-pocket loss, the benefit of the bargain, or some other appropriate standard."); *Herpich v. Wallace*, 430 F.2d 792, 810 (5th Cir. 1970) ("The gist of the Rule 10b-5 action for damages is economic injury to the plaintiff resulting proximately from the acts of the defendants which constitute a violation of the rule."); *Green v. Wolf*, 406 F.2d 291, 303 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969) ("We do not believe that Congress intended the Securities and Exchange Act to be used as a vehicle for the recovery of damages that could often be grossly disproportionate to the harm done."). We are required to look to the courts for a definition of "actual damages" because the legislative history of the term is of little help. See H.R. REP. NO. 1383, 73rd Cong., 2d Sess. 28 (1934) ("This subsection reserves rights and remedies existing outside of those provided in the act, but limits the total amount recoverable to the amount of the actual damages.").

191. See, e.g., *Byrnes v. Faulkner*, 550 F.2d 1303, 1313 (2d Cir. 1977) ("[section 28(a)] on its face precludes recovery of punitive damages"); *Green v. Wolf*, 406 F.2d 291, 303 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969) ("[P]unitive damages are not authorized in private actions under section 10(b) and Rule 10b-5.").

the language of the law under section 28(a) than there is under section 12(2).

The Court also stated that it was proper to award the plaintiffs more than their actual loss to prevent the defendant's unjust enrichment.¹⁹² This has been a goal of the federal securities laws¹⁹³ because any potential windfalls should inure to the plaintiff rather than the defendant.¹⁹⁴ Therefore, the *Randall* Court argued that a receipt of tax benefits by the investor, as well as full recovery under a rescissory measure of damages, did not exceed the "flexible limits of section 28(a)."¹⁹⁵

The Court, however, fails to recognize that the value of the tax benefits realized by the investor are not equal to the unjust enrichment enjoyed by the promoter. The investor generally pays a higher price for the tax shelter investment than he does for other investments that offer comparable cash flow and appreciation potential.¹⁹⁶ To the extent the tax benefits fail to materialize or are realized by the victim and then lost, the defendant is unjustly enriched only when he is allowed to retain the additional price or "premium" paid for the tax shelter investment.¹⁹⁷ Returning this premium to the victim remedies the unjust enrichment. Allowing a full recovery without considering the tax benefits realized by the investor does not.

The Supreme Court also argued that the larger award for damages in a private action served to deter prospective fraud in the securities marketplace and insured that the disclosure requirements of the federal securities laws were met.¹⁹⁸ However, these purposes can be met adequately through enforcement of the criminal sanctions available under the securities laws.¹⁹⁹ In addition, compensatory damages alone can have a significant deterrent effect, especially in large class action cases.²⁰⁰ Lastly, a larger federal

192. 106 S. Ct. at 3153.

193. See generally Thompson, *supra* note 33.

194. "It is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." Nelson v. Serwold, 576 F.2d 1332, 1339 (9th Cir. 1978) (citing Janigan v. Taylor, 344 F.2d, 781, 786 (1st Cir. 1968)).

195. 106 S. Ct. at 3153.

196. 4 R. HART & P. FASS, TAX SHELTERED INVESTMENTS § 0.06, at 8-9 (3d ed. 1981).

197. This premium paid represents the present value of anticipated future tax savings. *Salcer* SEC Brief, *supra* note 64, at 9 n.12.

198. 106 S. Ct. at 3154. See *supra* notes 140-41 and accompanying text.

199. The criminal sanctions can be found in section 24 of the 1933 Act, 15 U.S.C. § 77x (1982) and section 32 of the 1934 Act, 15 U.S.C. § 78ff (Supp. 1985).

200. See, e.g., *DeHaas v. Empire Petroleum, Co.*, 435 F.2d 1223, 1231 (10th Cir. 1970) ("Since [class actions and derivative actions] allow many small claims to be litigated in the same action, the overall size of the compensatory damages alone may constitute a significant deterrent."); *Green v. Wolf*, 406 F.2d 291, 303 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969) ("[C]lass actions, derivative suits and other such procedural devices provide sufficient incentive to insure that those injured by a violation of 10b-5 will have adequate opportunity to confront alleged malefactors and to have appropriate sanctions imposed upon them."). There also exists "the psychological deterrent of being branded a knowing violator of the law." *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1285 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). See

damage award combined with pendent state claims, which allow punitive damages, may provide the plaintiff with a double recovery.²⁰¹

Section 28(a) requires that the investor be awarded no more than his actual damages and section 12(2) requires that damages be reduced by income received.²⁰² If Congress intended a stronger deterrent, it could have provided for an express measure of punitive damages²⁰³ instead of allowing recovery only for an out-of-pocket loss or rescission.²⁰⁴ Because such expansive language is not explicitly provided by the legislature, it is not proper for the courts to provide such expansive meaning to the language.

IV. TAX TREATMENT OF DAMAGES

By holding that tax benefits are to be ignored in computing rescissionary damages in securities fraud litigation, the *Randall* Court does not attempt to clarify the proper tax treatment of such awards.²⁰⁵ The Court merely mentions the tax benefit rule²⁰⁶ and states that there are too many difficulties in predicting the ultimate treatment of the investor's claimed tax benefits.²⁰⁷ However, if an accurate measure of damages is to be made, so that the parties are returned to the *status quo ante*, the tax implications of the transaction cannot be ignored.²⁰⁸

Tax benefits have real economic value and in some cases are readily transferable to other parties under the Internal Revenue Code.²⁰⁹ To the

generally Hirsch & Lewis, *Punitive Damage Awards Under the Federal Securities Acts*, 47 NOTRE DAME L. REV. 72 (1971).

201. "The statutory language suggests that one purpose of section 28(a) is to prevent double recovery by those who assert both state and federal claims arising out of the same conduct." *Osofsky v. Zipf*, 645 F.2d 107, 111 (2d Cir. 1981) (citing 3 L. LOSS, SECURITIES REGULATION 1624 n.5 (2d ed. 1961)).

202. See *supra* notes 20-21 (text of statutes).

203. See, e.g., Sherman Antitrust Act, 15 U.S.C. §§ 1-7 (1982) (provides for treble damages).

204. See *supra* note 31 and accompanying text (discussion of out-of-pocket loss).

205. The Court's statements, if anything, only added to the confusion regarding this question. See *supra* note 139 and accompanying text.

206. 106 S. Ct. at 3154.

207. *Id.* However, many tax experts believe that a reasonable estimate of the tax benefits can be made. See, e.g., Banoff, *Supreme Court Holds Tax Shelter Benefits Do Not Offset Rescission Damages*, 64 J. TAX'N 210, 213 (1986) (in his discussion of the computation of damages for tax shelter fraud, the author says that "[d]espite [the existing] uncertainties and complexities, it usually will be possible to reach an approximate determination of the net tax benefits to the plaintiffs.").

208. See *supra* notes 32-34 and accompanying text.

209. One example is the safe harbor leasing provisions enacted under the Economic Recovery Tax Act, Pub. L. No. 97-34 (1981). Using these rules, "three party financing leases or leverage leases are often used to transfer tax benefits from users of property who do not have sufficient tax liability to absorb those benefits." 5 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 23.65 (rev. ed. 1986). "Since Congress recognized that many businesses would not be able to completely use the increased cost recovery allowances under ACRS (Accelerated Cost Recovery System), it decided to facilitate the transfer of ACRS benefits through these types of transactions." *Id.*

extent tax benefits promised to an investor fail to materialize, full recovery is allowed in court.²¹⁰ The SEC has also recognized the importance of these benefits in real estate limited partnerships because it requires the offerer to disclose information regarding potential tax write-offs that might be generated by the investment.²¹¹

In some cases, such as when the investor's tax returns are subject to audit, i.e., the statute of limitations on assessments has not run,²¹² the evidence concerning tax benefits "may be so speculative as to be beyond the jury's province."²¹³ If evidence as to tax benefits is allowed, the plaintiff would be forced to argue in court that the tax benefits will be recaptured while arguing before the IRS that the benefits should stand.²¹⁴ However, in most cases, as in *Randall*, the statute of limitations on assessments has already run on the relevant years²¹⁵ and it is only a matter of comparing the tax treatment of the damages award with the tax benefits already realized. If the tax liability arising from the damage award is equal to the tax benefits previously recognized by the investor, the full amount of the rescissionary damages should be paid by the defendant. In this way, the investor will be made whole after he pays the required taxes on his damage award. If the tax benefits previously realized by the investor exceed his subsequent tax liability arising from the damage award, his compensation should be adjusted downward accordingly.²¹⁶

Because the Supreme Court does not provide any clear statements on the tax consequences of rescission damage awards under the federal securities laws, the confusion surrounding the tax treatment of such awards still remains.²¹⁷ It is fairly certain that the IRS will treat the rescission as a second independent transaction that will not change the parties' tax

210. See, e.g., *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982) (investor in a limited partnership oil and gas drilling venture successfully sued an accounting firm for preparing a misleading tax opinion letter).

211. See SEC Industry Guide No. 5, *Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships*. See *supra* note 143.

212. See *supra* note 72 (statute of limitations on assessments).

213. 106 S. Ct. at 3154.

214. See Banoff, *To What Extent Will Benefits From Tax Shelters Be Permitted to Offset Rescission Damages?*, 57 J. TAX'N 154, 155 (1982) ("Proof of the weaknesses of the partnership's tax shelter benefits will be of public record in the rescission litigation, and well may serve as a road map to the IRS on its ongoing audit."); Garahan, *Should Tax Shelter Benefits Offset Recoveries For Securities Law Violations?*, 2 J. TAX'N INV. 302, 307 (1985) ("Here the investor is clearly caught between a rock and a hard place if the taxable years in question are still open. To reduce any offset, he must argue against the validity of his own tax return positions.").

215. *Austin II*, 768 F.2d 949, 955 (8th Cir. 1985) ("All of the plaintiffs' tax returns from the relevant years have already been audited and are now closed.").

216. This payment is currently deductible by the defendant under I.R.C. § 162(f) (1982). However, proposed Bill H.R. 2473, "Deduction Disallowance for Damages for Fraud Violations," would disallow any tax deduction for damage payments made pursuant to the convictions for crimes involving fraud. Banoff, *supra* note 207, at 214.

217. See *supra* notes 57-60 and notes 84-88 and accompanying text.

treatment of the original sale.²¹⁸ Thus, any gain will be recognized in the current year and will not require amending returns from prior years.²¹⁹ However, it is uncertain whether this independent transaction will be treated as a payment to a retiring partner,²²⁰ a sale or exchange of a partnership interest,²²¹ or a recapture of all previous benefits realized under the tax benefit rule.²²² Due to the Court's holding in *Randall*, neither Congress nor the IRS has any incentive to eliminate the confusion.

The rules limiting tax shelter write-offs and the reduction in personal income tax rates under the 1986 Tax Reform Act will likely decrease the popularity of these tax-motivated investments.²²³ Therefore, the holding in *Randall v. Loftsgaarden* may have a limited impact on tax shelter securities fraud litigation in the distant future. However, in the next few years as fraudulent tax shelter offerings not covered by the new tax law are litigated, the *Randall* doctrine will have a substantial impact on the computation of rescissionary damages. Consequently, defendants will be in a much less favorable bargaining position in structuring out-of-court settlements. In addition, the *Randall* Court's holding encourages the lower courts to continue the present practice of generally ignoring the tax aspects of most civil damage awards.²²⁴

Permitting the consideration of tax benefits in the calculation of damages in tax shelter securities fraud litigation, would allow courts to make a more

218. In *Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940), a taxpayer was credited with earnings from a corporate employee benefit fund in 1930. The plan was rescinded in 1931 as a result of suits filed by shareholders. The court held that due to the annual accounting period principle, the employee's taxable income for 1930 was to include the fund earnings and was to be determined without regard to the subsequent rescission of 1931. See also Rev. Rul. 80-58, 1980-1 I.R.B. 181 (gain on sale of land made in 1978 should be recognized in 1978 even though the property was reconveyed in 1979 pursuant to the terms of the sales contract). See generally Banoff, *supra* note 91, at 970-72.

219. This is contrary to the Ninth Circuit's position in *Burgess*. See *supra* note 59 and accompanying text.

220. The transaction may be treated as a payment to a retiring partner where the partnership is still in existence and solvent. Banoff, *supra* note 91, at 970. The partnership is viewed as reacquiring the partnership interest in return for the investor's cash. *Id.* Under I.R.C. section 736(b) (1982), payments to a retiring partner are taxable to the recipient as distributions in liquidation of a partnership interest which may be given either capital gain or ordinary income treatment. 2 W. MCKEE, W. NELSON, & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* § 15.02[1] (1986). However, if such payments are made for unrealized receivables or goodwill of the partnership, they are taxable to the recipient under section 736(a) either as a distributive share of partnership income or as guaranteed payments. *Id.* In either case, the retiring partner generally recognizes ordinary income. *Id.*

221. The payment of damages may be viewed as a sale or exchange of a partnership interest between the defrauded investor and the defendant. Banoff, *supra* note 91, at 971. Therefore, the transaction would probably be given capital gain or loss treatment under I.R.C. § 741 (1982). *Id.*

222. The investor would recognize ordinary income to the extent he deducted ordinary losses in previous years. See *supra* notes 57-60 and accompanying text.

223. See *supra* note 27 (Tax Reform Act of 1986).

224. See *supra* notes 2-8 and accompanying text.

accurate determination of the loss actually sustained by the investor. Jury consideration of the plaintiffs' tax benefits is no more uncertain or speculative than many other determinations made by the courts.²²⁵ Unfortunately, the Supreme Court's holding in *Randall* denies courts the opportunity to properly compensate defrauded investors in accordance with the federal securities laws.

CONCLUSION

Randall v. Loftsgaarden holds that courts are not to consider tax benefits realized when awarding rescissory damages to the victims of fraudulent tax shelters, pursuant to the federal securities laws. In doing so, the Court read the securities statutes so as to exclude these benefits from any consideration of damages. Consequently, courts are not given the opportunity to further the goals of rescission, the form of recovery provided for by the securities laws.

If Congress wants to deter securities fraud and insure the veracity of the information before the investor, it should provide for a much harsher civil penalty under the law. It is not for the courts to expand the scope of the securities laws to conform to their perception of congressional intent. Because of the Court's rejection of the tax benefit defense, *Randall v. Loftsgaarden* does not provide any guidance as to the tax treatment of rescissory damages awarded under the securities laws. Therefore, Congress and the IRS have no incentive to provide a much needed clarification of the tax law in this area.

Paul J. Gaeto

225. "[T]he practical wisdom of the trial bar and the trial bench has developed effective methods of presenting the essential elements of an expert calculation in a form that is understandable by juries that are familiar with the complexities of modern life. We therefore reject the notion that the introduction of evidence describing a decedent's estimated after-tax earnings is too speculative or complex for a jury." *Norfolk & W. Ry. v. Liepelt*, 444 U.S. 490, 494 (1980).

